IN THE

SUPREME COURT

OF THE

UNITED STATES.

October Term, 1939.

No. 15.

BOTELER, Trustee of the Estate of RICHMAID CREAMERIES, INC., a corporation, Debtor,

Petitioner,

vs.

INGELS, Director of Motor Vehicles of the State of California; HOWARD E. DEEMS, as Registrar of Motor Vehicles of the State of California, and the MOTOR VEHICLE DEPARTMENT OF THE STATE OF CALIFORNIA,

Respondents.

No. 16.

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Respondents.

PETITIONER'S OPENING BRIEF.

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OPINION BELOW.

No opinion was written by the District Court. The opinion of the United States Circuit Court of Appeals for the Ninth Circuit was filed December 15, 1938, and is reported in 100 Fed. (2d) 915.

JURISDICTION.

By stipulation of counsel and order of the United States Circuit Court of Appeals for the Ninth Circuit, the above-numbered appeals, in which separate transcripts of records have heretofore been filed, were consolidated. Accordingly one opinion was rendered by the Circuit Court for the two cases. For purposes of convenience, the transcript of the record in case No. 15 will be referred to as R. I, and the transcript of record in case No. 16 will be referred to as R. II.

Jurisdiction of this Court is invoked under the writ of certiorari granted by it in the above-entitled cases on the 24th day of April, 1939. *Section 240, Judicial Code, 28 U. S. C. A. 347.*

STATEMENT OF THE CASE.

Briefly stated, the facts involved in these cases are as follows:

Richmaid Creameries, Inc., was engaged in the creamery business and owned certain milk and ice cream routes, operating twenty-seven automobiles and trucks in the course of such business [R. II, 5]. Under date of September 16, 1936, it filed its petition under Section 77B of the Bankruptcy Act [R. II, 5]. A temporary Trustee was appointed [R. II, 5]. Thereafter and on December 22, 1936, the District Court, finding that the operations

of the temporary Trustee resulted only in loss, entered its order of liquidation and referred the case to the Referee in Bankruptcy [R. II, 6]. On January 20, 1937, L. Boteler was appointed Trustee in Bankruptcy for the purpose of liquidating the assets of Richmaid Creameries, Inc. [R. II, 6]. Inasmuch as the assets were of little value in liquidation unless deliveries on the milk and ice cream routes were maintained, the Trustee continued to operate the business until February 28, 1937, when the Referee in Bankruptcy approved a sale of the routes and certain equipment [R. I, 67; R. II, 6, 7]. In order to keep operating, upon a number of occasions, the Trustee was compelled to advance his own personal funds to the estate so that there would be no cessation in the making of deliveries [R. II, 7].

The California motor vehicle license fees become due on January 1st of each year. If such fee is not paid within thirty days a penalty designated by statute attaches. The penalty is added to the fee on all applications for renewals and transfers on and after February 5. The California statute further provides that the fees and penalties constitute a lien on the vehicle from which such fee and penalty is due from the time the same becomes due.

On January 1, 1937, and between January 1, 1937 and February 27, 1937, the Trustee did not have sufficient funds in the estate with which to pay the California motor vehicles license fees on the twenty-seven automobiles and trucks owned by the estate [R. I, 70].

On or about February 27, 1937, the Trustee applied to the Department of Motor Vehicles of the State of California for 1937 license plates on the motor vehicles belong-

ing to the bankrupt estate [R. II, 8]. He tendered all of the fees due, but not the penalties [R. II, 8]. The department refused to issue the licenses unless the fees were accompanied with the penalties [R. II, 8].

Thereafter the Trustee, by petition, secured an order and an amended order from the Referee in Bankruptcy to compel respondents herein to show cause why the penalties should not be set aside; why the 1937 license plates should not be issued on the payment of the fees, exclusive of the penalties; why the respondents should not be required to immediately file such claims as they asserted to the bankrupt estate or be forever barred; and why the Trustee should not be authorized to sell the motor vehicles free and clear of any and all liens claimed by the Motor Vehicle Department upon said vehicles [R. I, 10, 17-18]. Following a hearing, the Referee made an order setting aside all of the penalties assessed against the motor vehicles and directing the Trustee to sell them free and clear of any and all liens thereon [R. I, 43, 44]. The order further commanded the respondents Ingels and Deems to file claims in bankruptcy for the registration and license fees upon said motor vehicles within thirty days from the date of the order or be forever barred [R. I, 44]. A petition to the District Court to review said order was denied and the order of the Referee was confirmed [R. I, 61].

The Trustee had also petitioned the Referee for an order directing the respondents to accept the principal

of the license fees in full payment of any and all sums owing by the bankrupt estate on said motor vehicles and enjoining collection or attempted collection by them of any penalties under the California statutes [R. I, 15]. The Referee declined to include such mandate in his order and an application was made by the Trustee to the District Court for a mandatory injunction to such effect [R. II, 9-15]. The District Court issued such an order [R. II, 15-17]. Appeal was allowed the respondents from each order, the former culminating in case No. 8711 in the Circuit Court of Appeals for the Ninth Circuit and the latter being case No. 8761 in said Circuit Court [R. I, 103-104; R. II, 33-34]. Since both cases involved identical facts, they were consolidated for briefing and hearing and were disposed of in one opinion by the Circuit Court.

The Circuit Court of Appeals for the Ninth Circuit reversed the order of the District Court in each case, with directions to order the registration and license fees and accrued penalties paid, or, in the alternative, to permit the vehicles to be disposed of, subject to a lien of the State of California for the unpaid taxes and penalties [R. I, 144-145; R. II, 57-58]. The Circuit Court held that because the taxes were not due and payable at the time of the filing of the petition they were not "provable" debts and therefore unaffected by the prohibitions of Section 57*j* of the Bankruptcy Act (11 U. S. C. A., Sec. 93(j)) [R. I, 137-140]. The Court further held that, by virtue of the Act of June 18, 1934 (48 Stats. 993; 28 U. S. C. A.,

Sec. 124(a)), the Trustee in Bankruptcy is subjected to the *penalties* and lien of the State of California [R. I, 141].

In reaching its conclusion the Court was confronted with the decision to the contrary of the Circuit Court of Appeals for the Seventh Circuit, to-wit, the case of *In re Messenger's Merchants Lunch Rooms, Inc.*, 85 Fed. (2d) 1002 [R. I, 144]. The Honorable Ninth Circuit Court declared:

> "In so far as the decision *In re* Messenger's Merchants Lunch Rooms, Inc. (C. C. A. 7), 85 Fed. (2d) 1002, cited by the appellee as authority for affirmance, is in conflict herewith, it is expressly disapproved."

A writ of certiorari was granted by this Honorable Court on April 24th, 1939.

SPECIFICATIONS OF ERROR.

The Circuit Court of Appeals erred in each of the following particulars:

1. In holding that Section 57*j* of the Bankruptcy Act is not applicable to penalties which accrue during the course of the administration of a bankrupt estate, while the estate is being operated incidental to its liquidation.

2. In holding that the State of California has a lien on the property of the bankrupt estate, which lien accrued during the course of administration of the bankruptcy estate.

3. In holding that the Act of June 18, 1934 (48 Stat. 993, 28 U. S. C. A., Sec. 124(a)), subjects the Trustee in Bankruptcy to liability for penalties attached to state taxes.

4. In holding that both the District Court and the Referee in Bankruptcy erred in finding that the Trustee had no funds with which to pay the motor vehicle taxes.

SUMMARY OF ARGUMENT.

(1) Section 57*j* of the Bankruptcy Act relieves trustees in bankruptcy from any liability on account of penalties incorporated into state taxing statutes.

(2) Section 57*j* of the Bankruptcy Act is not limited in its application to taxes which accrued prior to bankruptcy; but applies equally as well when taxes are accrued by the bankruptcy estate during the operations of a trustee in bankruptcy.

(3) The Act of Congress of June 18, 1934, does not subject trustees in bankruptcy to state taxing penalties.

(4) The Act of Congress of June 18, 1934, does not operate to repeal Section 57*j* of the Bankruptcy Act.

(5) The Circuit Court of Appeals erred in refusing to accept the findings of fact concurred in both by the District Court and the Referee in Bankruptcy to the effect that at the time the taxes accrued in the cause herein the Trustee did not have funds with which to pay such taxes, and that the Trustee was not negligent in his failure to pay the taxes at the time that they accrued.

ARGUMENT.

(1) Section 57j of the Bankruptcy Act Relieves Trustees in Bankruptcy From Any Liability on Account of Penalties Incorporated Into State Taxing Statutes.

It is appropriate to first quote the relevant portions of the applicable statutes involved in this case.

Section 3 of the California Vehicle License Fee Act, as amended by Chapter 6 of California Statutes of 1937:

> "Except as hereinafter provided, the license fee hereby imposed shall be due and payable to the department on the first day of January of each year. Such fee shall be paid to the department at the time of registration or renewal of registration of such vehicle." (Chap. 362, Cal. Stats. 1935, as amended by Chap. 6, Cal. Stats. 1937, p. 62.)

Section 6 of the California Vehicle License Fee Act (*ibid.*):

> "Whenever any vehicle is operated upon any highway of this state without the license fee having first been paid as required by this act, such fee is delinquent. If such fee is not paid within thirty days after the same becomes delinquent, a penalty equal to one-half such fee shall be added thereto and collected therewith. If, however, the annual registration of a vehicle is being renewed, such penalty shall be added to any payment made on or after February 5, unless the vehicle has not been operated on the highways since the expiration of the prior registration.
>
> "* * * Every license fee and any penalty added thereto, from the date the same becomes due, constitutes a lien upon the vehicle for which due."

Section 378 of the California Vehicle Code:

"When Fees Delinquent. Penalties.

(a) Whenever any vehicle is operated upon any highway of this state without the registration fee having first been paid as required by this code, such fee is delinquent.

(b) A penalty shall be added upon any application for annual renewal of registration made on or after February 5, unless the vehicle has not been operated on the highways since the expiration date.

(c) Except as otherwise provided in subdivision (b), if any fee is not paid within thirty days after the same becomes delinquent a penalty shall be added thereto.

(d) In every event the penalty shall be equal to the fee and shall be collected therewith."

Section 379(a) of the California Vehicle Code:

"Every registration or transfer fee and any penalty added thereto, from the date the same became due, constitute a lien upon the vehicle for which due."

Section 57*j* of the Bankruptcy Act:

"Debts owing to the United States, a state, a county, a district, or a municipality as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued thereon according to law." (11 U. S. C. A., Sec. 93(j).)

Act of Congress, June 18, 1934:

"Any * * * trustee * * * appointed by any United States Court who is authorized by said

court to conduct any business, or who does conduct any business, shall * * * be subject to all state and local taxes applicable to such business the same as if such business were conducted by an individual or corporation * * *." (48 Stat. 993, 28 U. S. C. A., Sec. 124(a)).

In conformity with Section 57*j* of the Bankruptcy Act, it has been uniformly held that penalties on debts due to a State are not recoverable. *In re York Silk Mfg. Co.*, 188 Fed. 735, affirmed *Pennsylvania v. York Silk Mfg. Co.*, 192 Fed. 81, appeal dismissed 34 Supreme Court 601, 231 U. S. 718, 58 L. Ed. 813 and certiorari denied 34 Supreme Court 602, 232 U. S. 724, 58 L. Ed. 815. In that case the District Court, at page 739, Vol. 188 Federal Reporter, said:

"It will thus be seen that under these circumstances penalties are not even provable in bankruptcy, and can only be allowed for the amount of the pecuniary loss sustained by the act, transaction or proceeding out of which the penalty or forfeiture arose, with reasonable and actual cost occasioned thereby, and such interest as may have accrued thereon according to law. * * * These penalties must therefore be disallowed entirely, but without prejudice to the State to make a claim as provided for in the above section."

In *People v. Jersawit*, 44 S. Ct. 127, 263 U. S. 493, 68 L. Ed. 405, the Supreme Court disallowed a claim for a penalty, stating on page 407:

"There can be no doubt that the additional 10% charged for failure to pay by January 1st is a penalty disallowed by the Bankruptcy Act, Sec. 57j (Comp. St., Sec. 9641) * * *."

In *United States v. Birmingham Trust Co.*, 258 Fed. 562, the court, at page 564 said:

> "Under the provisions of this section (Sec. 57j), it seems clear the right of the United States to claim the penalty or forfeiture is denied except as to the actual pecuniary loss suffered by the United States. * * * As there is no question or suggestion that in the matter of this penalty the United States suffered any pecuniary loss, it cannot be allowed." (Matter in parentheses ours.)

(2) Section 57j of the Bankruptcy Act Is Not Limited in Its Application to Taxes Which Accrued Prior to Bankruptcy; but Applies Equally as Well When Taxes Are Accrued by the Bankruptcy Estate During the Operations of a Trustee in Bankruptcy.

The Circuit Court of Appeals in its opinion in the instant case held that Section *57j* of the Bankruptcy Act is applicable only to debts or claims which are provable in bankruptcy. The Circuit Court held that because the tax accrued subsequent to the filing of the petition in bankruptcy, that the tax was not a provable claim or provable debt within the meaning of the Bankruptcy Act and therefore was not subject to the prohibition of Section *57j* of the Bankruptcy Act. In this reasoning the Circuit Court of Appeals for the Ninth Circuit has seen fit to restrict the term "debt" to that of a provable claim in bankruptcy. Section 57 of the Bankruptcy Act (U. S. Code, Title 11, Chap. 6, Sec. 93) deals with the proof and allowance of claims in bankruptcy. It is of particular importance that throughout the section Congress repeatedly used the term "claims" and in only one instance did Congress use the

term "debts". The term "debts" is exclusively used in subdivision *j* of Section 57 which refers to indebtednesses owing to the United States, a State, a county, a district, or a municipality. To give significance to the fact that the term "claim" is used in all other instances within Section 57 which have reference to the proof and allowance of claims in bankruptcy, but utilizes a different term, to-wit, "debts" with reference to penalties or forfeitures in connection with governmental agencies, it may reasonably be inferred that Congress was not confining the scope of the Act to mere provable "claims" in bankruptcy, but that it used the term "debts" so as to embrace indebtednesses other than provable "claims". While it may be admitted that had Congress used the term "claims" in connection with subdivision *j* of Section 57 of the Bankruptcy Act, that it might possibly be inferred therefrom that only provable claims such as arose previous to the filing of the petition in bankruptcy only were included; the fact that a broader designation was used indicates the intent of Congress to prohibit the collection of penalties on taxes whether accrued previous to the filing of a petition in bankruptcy or subsequent to the filing of the petition in bankruptcy.

The purpose of Congress in enacting Section 57*j* of the Bankruptcy Act is apparent from its face. This section prohibits the allowance of penalties or forfeitures except for the amount of the pecuniary loss sustained by the act out of which the penalty arose. This is a recognition of the fact that the creditors for whom the bankruptcy estate is being administered should not suffer any depreciation from their recovery of the bankruptcy estate, on account of tax claims other than those which represent actual taxes incurred or actual loss accruing to the taxing body.

"The purpose of subsection j is clear. The creditors are not to be mulcted 'except to the amount of the pecuniary loss sustained,' interest and costs, because of debts owing the sovereign as a penalty or forfeiture." *Gilbert's Collier on Bankruptcy*, 4th Edition, Section 1064, page 783.

"In many branches of bankruptcy law, the legal principles established are very different from those which govern solvent persons and corporations. The rules of set-off and of priority can be mentioned as only two out of many examples. In enacting section 57j, Congress was no doubt motivated by the fact that it was dealing with insolvent persons and corporations, unable to meet their obligations, and that any tax penalty collected would punish not the insolvent, but his creditors. Congress doubtless also recognized that the other purpose of a penalty—to induce the individual subject to a tax to pay it promptly—is inapplicable where he is unable to do so. Consequently, in dealing with tax claims in bankruptcy proceedings, Congress has said in effect: 'All ordinary taxes are to be paid ahead of general claims, but the estate should not bear the burden of unusual and extraordinary exactions imposed for reasons which have no application in bankruptcy proceedings.'" *In re Standard Composition Co.*, 23 Fed. Supp. 391, 395.

The Circuit Court below recognized the fact that had the penalty herein arisen prior to the filing of the petition in bankruptcy that Section 57*j* would bar the recovery of such penalty. It asserts, however, that a different rule is applicable because of the fact that the penalty accrued during the administration of the bankruptcy estate by the trustee in bankruptcy. We respectfully submit that the basis for such a conclusion by the Honorable Circuit

Court below is purely a technical one and unsustained by legislative intent. In substance, there is no reason why the rule should be different in cases where the penalty arises during the operations of the bankruptcy estate by a trustee in bankruptcy from those cases where the penalty accrued prior to bankruptcy. In either event, the purpose of Congress was to avoid the distribution of a bankruptcy estate in such a way as to compensate creditors and claimants for any amount other than actually represented substantial and meritorious considerations. It was intended that creditors should not be made to suffer any diminutions of their recovery of the assets of a bankrupt estate because of punitive provisions in taxing statutes.

A penalty is not a tax.

In the case of *In re York Silk Mfg. Co.*, 188 Fed. 735, the Court, at page 739, said:

> "It is perfectly manifest that they (penalties) are not taxes within the meaning of the law; * * *." (Matter in parentheses ours.)

Note the definition of penalty in 25 *Corpus Juris* 1178. Section 72, wherein it is stated:

> "A penalty is a sum of money of which the law exacts payment by way of punishment for doing some act that is prohibited or omitting to do some act that is required to be done."

In *Featherstone v. The People*, 194 Ill. 325, at page 334, the Court said:

> "Punishment is synonymous with penalty."

A penalty, therefore, is no part of the tax. It is a means of punishment and is utilized for the purpose of

compelling the payment of taxes. However, by the enactment of Section 57*j*, Congress saw fit to relieve bankruptcy estates from the necessity of the payment of penalties. The reasons which render it undesirable to permit the collection of penalties from the bankrupt estate are no different than cases wherein the tax accrues before or after the filing of the petition in bankruptcy. The technical ground upon which the Honorable Circuit Court of Appeals for the Ninth Circuit rested its decision, to-wit, that the use of the term "debt" should be defined as "provable claim" in bankruptcy, is neither warranted by the language of Section 57*j* of the Bankruptcy Act or by the congressional intent creating the section.

(3) The Act of Congress of June 18, 1934, Does Not Subject Trustees in Bankruptcy to State Taxing Penalties.

In addition to the ground hereinbefore mentioned, the Circuit Court of Appeals for the Ninth Circuit based its decision upon the further ground that the Act of June 18, 1934 (48 Stat. 993, 28 U. S. C. A., Sec. 124(a)), subjects the trustee to all state and local taxes "applicable to such business the same as if such business were conducted by an individual or a corporation". The Circuit Court said:

> "This is sufficient basis for the attachment of the penalty and lien."

This very act, however, serves the purpose of revealing that, although Congress intended to subject trustees in bankruptcy to state and local taxes, it did not subject trustees in bankruptcy to penalties. The section refers only to "taxes". Its silence as to "penalties" is therefore

vitally significant. We have heretofore shown that a penalty is not a tax—it is a means of punishment. Had Congress intended that receivers and trustees be subjected to penalties, the statute would not merely have recited that such receivers and trustees were to be subjected to all applicable state and local taxes. By the use of the word "taxes" Congress apparently meant to exclude receivers and trustees from being subject to "penalties".

> "It is insisted, however, that the Act of June 18, 1934, subjecting receivers in bankruptcy to liability for the occupational tax should be so construed as to eliminate the prohibition against recovery of penalties provided in Section 57j. The language of the act does not support this contention. *It applies only to taxes, not to penalties.* We are not justified in extending its purview." (Italics ours.)
>
> *In re Messenger's Merchants Lunch Rooms, Inc.*, 85 Fed. (2d) 1002.

To fully understand the purpose of 28 U. S. C. A., Section 124(a), which was adopted on June 18, 1934, consideration must be given to the status of the tax liability of receivers and trustees in bankruptcy prior to that date.

Prior to the passage of this statute courts had almost uniformly exempted receivers and trustees who operated businesses of bankrupts from the payment of federal, state or local taxes, unless such receivers and trustees were especially within the purview of the particular taxing statute.

The leading case on this proposition is *Reinecke v. Gardner*, 277 U. S. 239, 48 S. Ct. 472, certified to the Supreme Court from the Circuit Court of Appeals for

the Seventh Circuit. In that case the trustee had conducted the bankrupt's business at a substantial profit. Pursuant to order of court, the trustee paid interest on bonds secured by a trust deed on the bankrupt's property and, when filing an income taxe return, deducted the amount of interest from his gross income. The Commissioner of Internal Revenue disallowed the deduction and filed a claim for the additional income and also for an excess profits tax. One of the questions certified was whether a trustee in bankruptcy operating the business of a bankrupt corporation under order of court was subject to the excess profits tax in a case where the corporation, if itself conducting the business, would have been subject to the tax.

The Court, at page 241, said:

"As under the Bankruptcy Act the entire property of the bankrupt vested in the trustee, the income in question was not the income of the bankrupt corporation, but of the trustee and was subject to income and excess profits tax only if the statutes authorized the assessment of the tax against him. The Revenue Act of 1916, Ch. 463, 39 Stat. 756, and the War Revenue Act of 1917, Ch. 63, 40 Stat. 300, imposed income and excess profits taxes on *individuals, partnerships and corporations, but neither in terms mentioned trustees in bankruptcy as taxable persons.* (Italics ours.) But Section 13(c) of Acts of 1916 required trustees in bankruptcy of corporations subject to the income tax to make returns of net income, and provided that 'any income tax due on the basis of such returns * * * shall be assessed and collected in the same manner as if assessed directly against the corporation'. This section, as appellee concedes, by its terms, extends the tax imposed by Section 10 of the Act of 1916 to income received by

trustees in bankruptcy of corporations. See *United States v. Chicago & Eastern Ill. Ry. Co.*, 298 F. 779.

"In the next year Section 4 of Title I of the Act of 1917 imposed an income tax of 4 per cent 'in addition to the tax imposed' by Section 10 of the Act of 1916 as then amended on the same subjects taxed by section 10, and provided that 'the tax imposed by this section shall be computed, levied, assessed, collected, and paid upon the same incomes and in the same manner as the tax' imposed by Section 10. The respondent was thus subjected to the additional income tax of the later act.

"The case is different with respect to the excess profits tax. That tax was imposed by Title II of the Act of 1917 on corporations, partnerships and individuals engaged in trade or business. The title made no mention of executors, receivers, trustees or persons acting in a fiduciary capacity, and contained no language corresponding to the quoted provision of Title I, Section 4, extending the additional income tax to 'the same incomes' taxed by Section 10 of the Act of 1916. A tax imposed on corporations alone does not extend to a trustee in bankruptcy of a corporation. (Italics ours.) See *United States v. Whitridge*, 231 U. S. 144, 34 S. Ct. 24, 58 L. Ed. 159; *Scott v. Western Pacific Ry. Co.*, 246 F. 545; compare *Smietanka v. First Trust & Savings Bank*, 257 U. S. 602, 42 S. Ct. 223, 66 L. Ed. 39."

And on page 244 it said:

"Various reasons may be urged why Congress may not have intended to extend the excess profits tax to trustees in bankruptcy. But whatever purpose Congress may have had, we think the language of Section 212 falls short of indicating any intention to enlarge the classes of taxpayers mentioned in Title II. *The extension of a tax by implication is not*

favored. (Italics ours.) *United States v. Whitridge, supra; Smietanka v. First Trust & Savings Bank supra.*

"The Treasury Department itself has held that testamentary trustees and trustees of estates in process of distribution, notwithstanding the administrative provisions of the 1916 Act requiring them to make returns for income tax purposes, are not taxable for excess profits. L. O. 1100, 1-2 C. B. 230; S. M. 2384, III-2 C. B. 330.

* * * * * * *

"The first question is answered 'No'."

Thus, where the statute imposed a tax upon corporations, partnerships, and *individuals* engaged in business, the Supreme Court refused to extend, by implication, the tax to include trustees in bankruptcy, since no specific mention was made in the statute of trustees in bankruptcy.

In *U. S. v. Whitridge,* 231 U. S. 144, 58 L. Ed. 159, receivers in equity had been appointed by the Court to operate a street railway. Petitions were filed on behalf of the United States for an order on the receivers to make returns of net income for the years 1909 and 1910, as required by the Act of August 5, 1906, 36 Stat. at L., Chap. 6, pp. 11, 112-117. The petitions were denied and the appeal followed. The statute in question, so far as it is pertinent, follows:

"Sec. 38. That every corporation * * * organized for profit and having a capital stock represented by shares * * * organized under the laws of the United States or of any state * * * and engaged in business in any state * * * shall be subject to pay annual and special excise tax with respect to the carrying on or doing business by such corporation * * *"

The Court, at page 140, said:

"A reference to the language of the act is sufficient to show that it does not, in terms impose a tax upon the corporate property or franchise as such, nor upon the income arising from the conduct of business unless it be carried on by the corporation. Nor does it in terms impose any duty upon the receiver of a corporation, or of corporate property with respect to paying tax upon the income arising from the management of the corporate assets, or with respect to making any return of such income.

"And we are unable to perceive that such receivers are within the spirit and purpose of the act any more than they are in its letter. True, they may hold, for the time, all the franchise property of the corporation, excepting its primary franchise of corporate existence. In the present case, the receivers were authorized and required to manage and operate the railroad and to discharge the public obligations of the corporations in this behalf, but they did this as officers of the Court, and subject to the order of the Court; not as officers of the respective corporations, nor with the advantages that inhere in corporate organization as such."

Here we have an instance where the Court refused to subject receivers in equity to a tax because they were not specifically included within the terms of the statute. It should be noted that the taxes were levied upon the right to carry on a business, though the amount of the tax was computed upon the income.

In re Flatbush Gum Co., Inc., 73 Fed. (2d) 283 (November 5, 1934) (certiorari denied 55 Sup. Ct. 509), the Circuit Court of Appeals, Second Circuit, had for consideration the question of the right of the State of

New York to impose a tax upon the proceeds received by a receiver in bankruptcy from the liquidation of the tangible assets of the bankrupt. The New York State Sales Tax Law imposed a tax upon all persons for the privilege of selling tangible personal property at retail. The statute (Consolidated Laws, Chap. 60, Sec. 390) defined persons as including "an *individual*, partnership, society, association, joint stock company, corporation, and *any combination of individuals*". (Italics ours.) The District Court denied the claim of the state and the Circuit Court of Appeals, in affirming the decision, said, at page 284:

> "The statute imposes the duty to make a return and pay the tax upon every 'person' who sells tangible personal property at retail. And in Section 390 of the statute the legislature took care to declare that 'person' meant more than one who acts solely in his capacity as an individual. In so doing it included in the same category with an indivividual a 'co-partnership, society, association, joint stock company, corporation and any combination of individuals.' *Its failure to include a receiver in this enumeration was, we think, highly significant, and indicates an intention to permit such sales to be made by a receiver tax free.* Indeed, the tax being laid upon the 'privilege of selling', being imposed upon 'every person' and person being defined as above indicated, it is clear that a taxable sale is but the exercise of the privilege of selling by a person within the statutory definition. *An intention to tax retail sales made by receivers must be indicated by words which may reasonably be accepted to disclose it before courts may construe the statute to mean that for the coverage of taxing acts it is not to be extended by implication. Smietanka v. First Trust & Savings Bank,* 257 U. S. 602, 42 S. Ct. 223, 66 L. Ed. 391; *Gould v.*

Gould, 245 U. S. 151, 38 S. Ct. 53, 62 L. Ed. 211. Moreover, the issue here is closely analogous to that presented by the first question considered in *Reinecke v. Gardner*, 277 U. S. 239, 11 Am. B. R. (N. S.) 738, 48 S. Ct. 472, 72 L. Ed. 866. It was there held that the failure of Congress to use language clearly extending the excess profits tax of the 1917 Revenue Act (40 Stat. 300) to 'executors, receivers, trustees or persons acting in a fiduciary capacity' was a failure to tax a trustee in bankruptcy of a corporation who actually carried on the business of the corporation even though the corporation would have been subject to the tax had it been itself conducting its business. *The principle that taxation by implication is not favored controls this appeal and leads us to the conclusion that the statute does not reach the sale made by this receiver.* See *United States v. Whitridge*, 231 U. S. 144, 34 S. Ct. 24, 58 L. Ed. 159; *Scott v. Western Pacific R. Co.* (C. C. A.), 246 F. 545. Affirmed." (All italics ours.)

Subsequently, *In re Browning, King & Co., Inc.*, 79 Fed. (2d) 983 (November 5, 1935), the same Court again had occasion to construe the New York Sales Tax Law when the state appealed from an order denying its claim for taxes based upon sales at retail made in conduct of business by the receivers and trustees in bankruptcy. This case is identical in every respect with the instant case. The Court, in a memorandum *per curiam* decision, said:

> "Order affirmed on authority of *In re Flatbush Gum Co.*, 73 Fed. (2d) (C. C. A. 2d)."

In the light of the foregoing decisions one can perceive the obvious purpose of Congress in effecting Section 124, 28 U. S. C. A. This does not embrace, however,

any purpose to subject receivers and trustees in bankruptcy cases to the penalties which the bankruptcy courts have uniformly held to be not a part of the tax, but distinctly different from the tax and not allowable in courts of bankruptcy.

(4) The Act of Congress of June 18, 1934, Does Not Operate to Repeal Section 57j of the Bankruptcy Act.

As we have heretofore seen Section *57j* of the Bankruptcy Act was enacted by Congress for the purpose of preventing the collection of tax penalties in bankruptcy estates. We have further seen that the Act of Congress of June 18, 1934, which subjected trustees in bankruptcy to state and local taxes did not expressly include penalties. To accept the decision of the Circuit Court that the Act of Congress of June 18, 1934 subjects the trustee in bankruptcy to state tax penalties amounts to a repeal by implication of Section *57j* of the Bankruptcy Act, at least in so far as it refers to operations of the trustee in bankruptcy. It is fundamental law that repeals by implication are not to be favored by the courts. This Honorable Court has repeatedly so held.

See:

General Motors Acceptance Corp. v. United States, 286 U. S. 49, 52 S. Ct. 468;

United States v. Burroughs, 289 U. S. 159, 53 S. Ct. 574;

United States v. Jackson, 302 U. S. 628, 58 S. Ct. 390.

There is no reasonable basis upon which the Honorable Circuit Court below should have thus impliedly repealed Section *57j* of the Bankruptcy Act relative to the operations of the trustee in bankruptcy.

(5) The Circuit Court of Appeals Erred in Refusing to Accept the Findings of Fact Concurred in Both by the District Court and the Referee in Bankruptcy to the Effect That at the Time the Taxes Accrued in the Cause Herein, the Trustee Did Not Have Funds With Which to Pay Such Taxes, and That the Trustee Was Not Negligent in His Failure to Pay the Taxes at the Time That They Accrued.

The Referee in Bankruptcy found as a fact that at the time that the tax accrued in this case the trustee in bankruptcy did not have funds with which to pay the tax [R. I, 41]. The District Court rendered a similar finding [R. II, 24]. These findings were based upon competent evidence: The trustee testified:

> "I might say further that it became necessary myself from my own funds to pay cash to employees for a week or two after I got in there because of the inadequate daily receipts to keep the payroll going and buy the necessary requirements. *In other words, the reason for not paying this tax, one reason at least, was the inadequacy of money so to do.*" (Italics ours.) [R. I, 70.]

The Circuit Court below held that these findings were contrary to the true facts. It stated that large sums of money were received by the trustee during this time and were paid out *before* the license fees became subject to penalty.

We respectfully submit that the Honorable Circuit Court below should not have disturbed the findings of fact which were concurred in both by the Referee in Bankruptcy and the District Court. It has been repeatedly held that where both the Referee and the District Court concur in the findings of fact and that the findings are

based upon competent evidence, such facts are to be conclusively presumed.

> *Menson v. Williams,* 213 U. S. 453, 29 S. Ct. 519;
> *Page v. Rogers,* 211 U. S. 575, 29 S. Ct. 159;
> *Brislin v. Killanna,* 85 Fed. (2d) 667;
> *Moore v. Lane,* 84 Fed. (2d) 553;
> *Ott v. Thurston,* 76 Fed. (2d) 368;
> *In re Nathanson Bros. Co.,* 64 Fed. (2d) 912.

The Circuit Court overruled the finding of fact of the Referee and the District Court for the reason that the record reveals that there were receipts and disbursements during the period of time involved, as reflected by the reports of the receiver of receipts and disbursements between September 16, 1936, and January 19, 1937, and the reports of the trustee in bankruptcy of receipts and disbursements between January 20, 1937, and February 4, 1937. The report of the receiver of operations between December 16, 1936, and January 19, 1937, reveals:

> "The business was operated on a cash basis during this time, and this accrued payroll and other unpaid bills are outstanding as a result of losses in the operation of the business. * * * The greater part of these claims is for labor * * *." [R. I, 75.]

Paragraph VIII of this report reveals as follows:

> "There is attached hereto a list of accrued payroll remaining unpaid, to-wit, for services rendered during the temporary and permanent trusteeship of your petitioner. *That your petitioner paid payroll to the limit of his cash ability during his trusteeship,* but the attached Schedule 'B', pages one and two, show the name and amounts due to labor for labor actually

performed during the administration of your trustee, which claims are *preferred labor claims and costs of administration* * * *. *That during the course of administration of your trustee he had incurred debts which are prior debts and costs of administration.*" [R. I, 76, 77.]

Schedule "A", referred to in the receiver's report, shows a loss in operations by the receiver of $9,641.42 for the period commencing December 16, 1936, and ending January 19, 1937 [R. I, 79-80].

Schedule "B", referred to in the receiver's report, listed thirty-four employees who performed labor within the time mentioned and to whom there had become due the sum of $4,633.53 [R. I, 80-82].

Schedule "C" lists twenty-eight preferred creditors who became such during the receivership to whom there had become due $5,665.73 [R. I, 82-83].

As a result of the receivership activities between December 16, 1936, and January 19, 1937, preferred claims accrued in a total amount of $10,615.52 to a total of approximately one hundred and thirty-five different persons, firms and/or corporations.

The receipts of the trustee from the time of his appointment on January 20, 1937, to the date of the sale of the assets were inadequate to conduct the business and keep up the payroll [R. I, 69]. The report of the receiver and the testimony of the trustee reveal that the funds which came into the hands of the trustee were woefully insufficient to care for operating expenses. We feel that

the record conclusively supports the findings of the Referee in Bankruptcy and the United States District Court that during the course of the trustee's administration he was unable financially to pay the license and registration fees, and he was therefore not negligent in failing to pay such fees at the time that they became due.

Whether the trustee in the case herein was negligent or not, Section 57*j* would operate to prevent the collection of penalties against the estate. However, we feel that the Circuit Court below misunderstood the record when it came to the conclusion that there were sufficient funds with which the trustee could have paid the license fees involved herein.

The trustee testified that he had to take money out of his own pocket to pay many of the expenses of the estate. This type of conduct is purely a gratuity and certainly not mandatory on the part of a trustee in bankruptcy. However, the decision of the Circuit Court below has the effect of saying that unless the trustee had made payment of the taxes out of his own pocket, the estate should be penalized. It is our opinion that it was the possibility of just this type of situation which motivated the enactment of Section 57*j* of the Bankruptcy Act. The state should not be in a position to collect any more than the tax which is due and any other expense that it actually incurred. It should not be in a position to exact a large sum of money for purely punitive purposes, especially where, as in this case, there was no means by which the trustee could have paid the tax on time.

CONCLUSION.

In the determination of this case this Honorable Court is being called upon to construe the effect of Section 57*j* of the Bankruptcy Act. It is our position that the Circuit Court below erred in applying a harsh and limited construction to said section, which was not within the intent of Congress. The decision of the Circuit Court below makes it possible for taxing authorities to deplete an estate perhaps in its entirety, not only for taxes, but for *punitive measures,* while creditors, who parted with substantial considerations, are left without recompense. That Congress did not intend such inequality is obvious from the very standard which Section 57*j* maintains.

The decision of the Circuit Court below loses the spirit of the Bankruptcy Act itself. In the case of *In re Standard Composition Co.,* 23 Fed. Supp. 391, the District Judge was passing upon the penalty phases of the Social Security Act. In arriving at his conclusion he made the following pertinent observations:

> "The Bankruptcy Act, 11 U. S. C. A., Section 1, *et seq.,* was drafted with the principle that 'equality is equity' in mind, but there has been a tendency in recent years for the typical bankruptcy proceeding to resolve itself into a process in which one preferred party after another slices off a portion of the available assets, with little or none remaining for distribution to general creditors. This process ought not to be extended beyond the clear requirements of the controlling statutes."

In the same spirit we submit that, to do justice to the intent of Congress, the decision of the Circuit Court of Appeals for the Ninth Circuit in this case should be reversed.

Respectfully submitted,

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BRIEF FOR THE PETITIONER

IN THE

SUPREME COURT

OF THE

UNITED STATES.

OCTOBER TERM, 1939.

No. 15.

L. BOTELER, Trustee of the Estate of Richmaid Creameries, Inc., a corporation, Debtor,

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RAY INGELS, Director of Motor Vehicles of the State of California; HOWARD E. DEEMS, as Registrar of Motor Vehicles of the State of California, and the MOTOR VEHICLE DEPARTMENT OF THE STATE OF CALIFORNIA,

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PETITIONER'S BRIEF IN REPLY TO RESPONDENTS' ANSWERING BRIEF.

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PETITIONER'S BRIEF IN REPLY TO RESPONDENTS' ANSWERING BRIEF.

Petitioner Has Not Waived Any of His Specifications of Error.

In their brief filed in answer to Petitioner's opening brief, the Respondents assert that Petitioner has apparently abandoned his second specification of error (Respondents' Brief in Answer to Petitioners' Opening Brief, p. 10).

Specification of error No. 2 is as follows:

> "The Circuit Court of Appeals erred * * * in holding that the State of California has a lien on the property of the bankrupt estate, which lien accrued during the course of administration of the bankruptcy estate."

Petitioner files this reply brief so as to avoid the possible inference that such specification of error No. 2 has been waived. Petitioner by no means waives such specification. It was in the interest of brevity that Petitioner did not undertake to explain that whether or not the State of California had a lien upon the property involved in these cases, depends primarily upon the fundamental question of whether or not there was a valid indebtedness to the State of California. It is the position of the Petitioner herein that the State of California had no lien, for the simple reason that there was no liability for penalties applicable to the Trustee in Bankruptcy under section 57j of the Bankruptcy Act of 1898 as amended. It is elementary that a lien cannot exist without the existence of

an obligation for which it is security. Thus, *section 2909* of the *Civil Code* of the State of California provides:

"A lien is to be deemed accessory to the act for the performance of which it is a security, whether any person is bound for such performance or not, and is extinguishable in like manner with any other accessory obligation."

Pacific Finance Corp. v. Hendley, 119 Cal. App. 697, 703:

"In this state, the mortgage is but an incident of the indebtedness, the property is impressed with only a lien for the benefit of the mortgagee, the legal title remaining in the mortgagor. (*Blodgett v. Rheinschild,* 56 Cal. App. 736 (206 Pac. 674).) *There exists no lien without an obligation.* There can be no debt or other obligation to be secured. (17 Cal. Jur. 710.) So, therefore, necessarily when property is mortgaged it is put up as security only. The mortgage has no existence independent of the thing or debt secured by it. (*Estate of Fair,* 128 Cal. 607 (61 Pac. 184).) Therefore, in considering the scope and effect of a mortgage lien, some attention must be given the debt intended to be secured thereby." (Italics ours.)

It is stipulated in the agreed statement of Case No. 16 that the trustee offered to pay the license fees, but refused to pay any of the penalties added thereto [Tr., No. 16, p. 4]. Nor is it denied in Case No. 15 that the trus-

tee had tendered the full amount of the license fees, and refused to pay the penalties added thereto. This is evidenced by the testimony of the petitioner that he tendered to the Registrar of Motor Vehicles of the State of California a cashier's check in the amount of $410.90, which was the amount of the license fees without the penalties [Tr., No. 15, p. 41]. We do not believe that there will be any contradiction by the Respondents to the elementary rule that if a proper tender was made of the full amount of the actual indebtedness which the so-called lien of the State purported to cover, that thereupon the lien would be discharged because of such tender. (17 *R. C. L.*, Section 15, page 606.)

In this connection we do not wish to be understood as in any way conceding that a lien could attach to the property of the bankrupt estate during the period of time within which the property of such bankrupt estate was in *custodia legis* under the supervision of the bankruptcy court. Section 124a of the Act of June 18, 1934 (48 Stats. 993, 28 U. S. C. A. sec. 124a), merely provides that receivers and trustees shall be subject to all state and local *taxes*. It does not expressly include *liens*. We do not believe such section broad enough to show any legislative intent to subject property once in *custodia legis* to the operation of subsequent liens. It is quite apparent that to have done so would have made it possible for states by such legislation to cripple the effective administration of bankruptcy estates.

We do not believe that the Act of 1934 shows any intent to depart from the principle established by this Honorable Court as early as the year 1875 in the case of *Morgan v. Campbell,* 22 Wall., 89 U. S. 381, 22 L. Ed. 796, wherein this Honorable Court held that there has been no enactment permitting a lien to attach on property after it has been subjected to the jurisdiction of a court of bankruptcy. In that case the Court held that the object of the Bankruptcy Act of 1867 was to prevent the acquisition of any other liens than such as existed when the petition in bankruptcy was filed, and that any proceeding by which this was attempted was within the condemnation of the law.

On pages 18 to 22 of their answering brief, the Respondents cite cases which they believe sustain the validity of a lien presumably attaching after the property has come within the jurisdiction of a court of bankruptcy. With the exception of *State v. Hisey,* 84 Fed. (2d) 802, the cases cited are cases relative to the imposition of tax liability, and not to the imposition of liens upon property already in *custodia legis.* In the *Hisey* case the Honorable Ninth Circuit involved itself in the same error as it did in this case. No reason has yet been advanced why a state or an individual may subject property which is under the control and supervision of a court of competent jurisdiction to the usual consequences of a lien.

Respondents' Arguments in General Are Based Upon an Erroneous Hypothesis.

We believe that this case has been amply briefed and we do not desire to burden the court with lengthy additional argument. On the other hand, we deem it appropriate to direct attention to the salient error which permeates throughout Respondents' answering brief. It will be noted that almost all of the cases cited by the Respondents in their brief are equity receivership cases. Respondents appear to believe that these are relevant for the consideration of the question involved in this case. The equity receivership cases lose all meaning, however, when consideration is given to the fact that the exemption from liability to penalties is *peculiar to bankruptcy* and is not available in equity receivership. The exemption from liability to penalties is the result of the operation of *section 57j* of the Bankruptcy Act. Certainly, respondents do not contend that such section is available to equity receiverships. The cases thus cited by Respondents are afield from the relevant issues herein.

Perhaps this is made more obvious by noting that there are fundamental differences between bankruptcy and equity receiverships. Other than the reorganization and rehabilitation features of section 77b and their counterparts in the Chandier Act, bankruptcy essentially deals with *insolvent debtors* and seeks an equitable distribution and liquidation of the assets of the bankrupt. Equity receiverships, however, are not necessarily predicated upon insolvency. Equity receiverships arise where courts find equitable cause for subjecting property to the supervision and management of the court through receivership for various reasons such as mismanagement, preservation and

the like. Inasmuch as in an equity receivership the owner of the property may be far from insolvent and inasmuch as the purpose of such receivership is not necessarily liquidation and distribution, there is no reason to avoid the imposition of penalties for failure to pay taxes. On the other hand, in cases of bankruptcy, the bankruptcy court seeks to make an equitable distribution of what is left of the property of an insolvent debtor. Under such circumstances Congress has provided that the distribution shall be confined to substantial and meritorious claims. Inasmuch as a penalty is a means of punishment rather than evidence of the parting of valuable consideration, Congress has seen fit to provide through *section 57j* of the Bankruptcy Act that the penalties shall not be allowed in bankruptcy proceedings.

We believe that the purpose of Congress was well stated in the case of *In re Ashland Emery and Corundum Co.*, 229 Fed. 829, where the court, at page 831, said:

> "If the charge here in controversy is to be regarded as interest, the trustee ought to pay it. Penalties, however, stand upon a different footing. It cannot be said that a penalty imposed for failure to pay a tax is a part of the original tax, in the sense that interest is. By 'interest' is ordinarily understood a charge for the use of money or damages for the detention of it. A penalty, as applied to cases of this character, means a punishment imposed for failure to make payment on time. Section 64a contains no provision for the payment of penalties; and I do not think it can fairly be construed to include them, especially when, as here, the estate was in the course of administration during the entire period when they accrued. It does not seem just, nor to have been the

intention of Congress, that out of a delay in paying the tax caused by the bankruptcy proceedings the state should make a profit or exact a penalty at the expense, for instance, of workmen employed by the bankrupt."

Respondents contend that section 57j applies only to provable claims of taxes which accrued prior to the filing of a petition in bankruptcy. This contention embodies the essential error of the Honorable Circuit Court of Appeals for the Ninth Circuit in its decision of this case. It is significant that the Bankruptcy Act in no portion thereof provides for the filing of claims in bankruptcy based upon taxes. On the contrary, section *64a* of the Bankruptcy Act, dealing with the priority of debts, provides that the court shall order the trustee to pay all of the taxes due and owing by the bankrupt.

> "The court shall order the trustee to pay all taxes legally due and owing by the bankrupt to the United States, state, county, district, or municipality, in the order of priority as set forth in paragraph (b) hereof: Provided, that no order shall be made for the payment of a tax assessed against real estate of a bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court. Upon filing the receipts of the proper public officers for such payments the trustee shall be credited with the amounts thereof, and in case any question arises as to the amount or legality of any such tax the same shall be heard and determined by the court."
>
> *United States Code,* Sec. 64; Title 11, Chap. 7, Sec. 104.

It was to be anticipated by Congress that taxes would accrue both before and after the filing of the petition in bankruptcy. However, this is the only section providing for the payment of taxes, and consequently the courts have properly construed section 64a of the Bankruptcy Act as applying to both taxes accruing before and after the filing of petitions in bankruptcy.

In re William F. Fisher & Co., 148 Fed. 907, at 912:

> "And section 1, 30 Stat. 544 (U. S. Comp. St. 1901, page 3419), declares that the word 'debt' shall include any debt, demand, or claim provable in bankruptcy. Of course, a tax is provable in bankruptcy. * * * It seems to be the duty of the court to require such payment, even though no claim for the same shall have been presented in the manner or within the time prescribed by the bankruptcy act for the filing of claims. *It is true that section 64 does not, in express words, refer to taxes assessed or becoming due after the institution of bankruptcy proceedings. But it is settled law that the bankrupt's estate is taxable while it is in the hands of the bankrupt's trustees.*"

In re Ashland Emery & Corundum Co., 229 Fed. 829:

> "Section 64a contains no provision for the payment of penalties; and I do not think it can fairly be construed to include them especially when, as here, the estate was in the course of administration during the entire period when they accrued."

It has been held that it is unnecessary for a taxing body to file a claim in bankruptcy for taxes, unless required to do so by court order. It has been held to be the duty of

the trustee to search the records for the purpose of paying taxes.

Stanard v. Dayton, 220 Fed. 441; 241 U. S. 588, 60 L. Ed. 1190, 36 Sup. Ct. 395;

In re De Angeles, 36 Fed. (2d) 218;

Remington on Bankruptcy, Vol. 6, Sec. 2808, p. 405.

It follows, therefore, that section 57j was not intended to operate only in the event that a formal claim has been filed in bankruptcy based upon taxes. The existence of the tax itself relegates it to the status of a provable debt in bankruptcy. It also follows that only so much of that tax which represents the tax itself, including interest, and any actual costs or expenses incurred by the taxing authorities because of any delay in its non-payment can be collected from the bankruptcy estate for the reason that section 57j of the Bankruptcy Act provides that "penalties" are not allowable.

The leading case in which this Honorable Court held that the trustee in bankruptcy was subject to taxes which accrued during the administration of the estate is *Swarts v. Hammer*, 194 U. S. 441, 48 L. Ed. 1060, 24 Sup. Ct. 695. It is significant to note that in that case, although the court held that the trustee in bankruptcy was subject to tax accruing during his adminisration of the bankruptcy estate, there is an express recognition of the fact that the penalties involved had been disallowed by the District Court under section 57j. This case reveals that section 64a of the Bankruptcy Act applies both where the tax accrued prior to bankruptcy and where the tax accrued subsequent to bankruptcy. In either event penalties must be denied under section 57j.

In the case of *New Jersey v. Pressed Steel Car Co.*, 100 Fed. (2d) 147, the taxes accrued during the administration of the estate and penalties were denied because of the operation of section 57j.

There has been no material alteration of subdivision *a* of section 64 of the Bankruptcy Act of 1898.

We believe the history of the decisions of the federal courts reveal that during the existence of section 64a of the Bankruptcy Act, bankruptcy courts have applied said section to taxes whether they accrued previous or subsequent to the filing of the petition in bankruptcy. We do not believe that the novel distinction created by the decision of the Circuit Court below should now disturb the established practice of applying subdivision *a* of section *64* of the Bankruptcy Act to cases wherein the tax accrued subsequent as well as prior to the filing of the petition in bankruptcy. In the case of *Missouri v. Ross*, 299 U. S. 72, 81 L. Ed. 46, 57 Sup. Ct. 60, this Honorable Court held that the fact that Congress, in the face of decisions of lower federal courts, extending over a period of nearly thirty years, has permitted the clause pertaining to tax claims as it now appears in paragraph (6) of section 64b to stand without change in its phraseology, although amending section 64 of the Bankruptcy Act in other particulars, is persuasive evidence of the adoption by that body of such judicial construction. The court held that it would hesitate to disturb a construction placed upon such section which had always been unanimously followed by such lower courts for nearly thirty years. What was said in that case may be stated equally as well in the instant case:

Quite obviously, the determination of the question involved in the instant case depends upon the true legislative intent of Congress. An effective means of determining legislative intent may be found in the effect of subsequent legislative enactment. The Legislature is presumed to know both the language employed in former acts and the judicial construction placed upon them; and if in a subsequent statute on the same subject it uses different language in the same connection, the courts must presume that a change of the law was intended.

> *Louisville R. R. Co. v. Mottley,* 219 U. S. 467, 31 Sup. Ct. 265, 55 L. Ed. 297;
>
> *Johnson v. United States,* 225 U. S. 405, 32 Sup. Ct. 748, 56 L. Ed. 1142.

The enactment of the Federal Unemployment Tax Act (42 U. S. C. A. 301), and the Federal Insurance Contributions Act (Sec. 1400, I. R. C.), raised the question in the lower courts whether or not withholding the 90% credit because of failure of a bankrupt employer to pay the taxes on time constituted a penalty forbidden by section 57j of the Bankruptcy Act. A conflict of cases in the lower courts on this question now exists.

> *In re Standard Composition Co.,* 23 Fed. Supp. 391;
>
> *In re Hy Grade Meat & Grocery Co.,* 26 Fed. Supp. 294;
>
> *In re Illinois Art Industries,* 27 Fed. Supp. 334.

It was appropriate therefore for the 76th Congress at its first session to amend these two Acts for the purpose of definitely establishing the legislative intent. Amendments to both of these Acts were approved on August 10, 1939 (Chap. 666, 1st Session, 76th Congress).

Section 1601 of the Internal Revenue Code (Federal Insurance Contributions Act) was amended (the significant changes being italicised) as follows:

"(1) The taxpayer may, to the extent provided in this subsection and subsection (c), credit against the tax imposed by section 1600 the amount of contributions paid by him into an unemployment fund maintained during the taxable year under the unemployment compensation law of a State which is certified for the taxable year as provided in section 1603.

(2) The credit shall be permitted against the tax for the taxable year only for the amount of contributions paid with respect to such taxable year.

(3) The credit against the tax for any taxable year shall be permitted only for contributions paid on or before the last day upon which the taxpayer is required under section 1604 to file a return for such year; except that credit shall be permitted for contributions paid after such last day but before July 1 next following such last day, but such credit shall not exceed 90 per centum of the amount which would have been allowable as credit on account of such contributions had they been paid on or before such last day. *The preceding provisions of this subdivision shall not apply to the credit against the tax of a taxpayer for any taxable year if such taxpayer's assets, at any time during the period from such last day for filing a return for such year to June 30 next following such last day, both dates inclusive, are in the cus-*

tody or control of a receiver, trustee, or other fiduciary appointed by, or under the control of, a court of competent jurisdiction.

(c) *Limit on Total Credits.*—The total credits allowed to a taxpayer under this subchapter shall not exceed 90 per centum of the tax against which such credits are allowable."

Similarly, section 902 of the Social Security Act was amended (the significant amended portions being italicised) as follows:

"*S . 902.* (a) Against the tax imposed by section 901 of the Social Security Act for the calendar year 1936, 1937, or 1938, any taxpayer shall be allowed credit for the amount of contributions, with respect to employment during such year, paid by him into an unemployment fund under a State law—

(1) Before the sixtieth day after the date of the enactment of this Act;

(2) On or after such sixtieth day, with respect to wages paid after the fortieth day after such date of enactment;

(3) *Without regard to the date of payment, if the assets of the taxpayer are, at any time during the fifty-nine-day period following such date of enactment, in the custody or control of a receiver, trustee, or other fiduciary appointed by, or under the control of, a court* of competent jurisdiction.

(c) * * * The total credit allowable against the tax imposed by section 901 of such Act for the

calendar years 1936, 1937 and 1938, respectively, shall not exceed 90 per centum of such tax.

(i) *No part of the tax imposed by the Federal Unemployment Tax Act or by title IX of the Social Security Act, whether or not the taxpayer is entitled to a credit against such tax, shall be deemed to be a penalty or forfeiture within the meaning of section 57j of the Act* entitled 'An act to establish a uniform system of bankruptcy throughout the United States,' approved July 1, 1898, as amended."

Section 902, subdivision (c) (i) clearly reveals that Congress construed section 57j of the Bankruptcy Act as being applicable to taxes levied against the Trustee in Bankruptcy during administration and by reason thereof adopted the aforecited provision that such credit should not be deemed to be a penalty within the meaning of section 57j of the Bankruptcy Act. This must be self-evident. If section 57j did not apply to taxes levied against the trustee in bankruptcy, then the aforesaid section 902, subdivision (c) (i) of the Internal Revenue Code would have been merely an idle act on the part of Congress. Correct statutory interpretation requires that effect be given to every word and provision of an Act. To do so in this case, we must assume the premise that section 57j is applicable in connection with taxes levied against trustees in bankruptcy. It was to avoid such construction in connection with the aforecited Social Security Act that said amendment was adopted.

The Bankruptcy Law Is the Supreme Law of the Land.

The Honorable Circuit Court of Appeals for the Ninth Circuit in a number of its decisions, including the instant case, has fallen into the error of holding that all State laws of whatever nature are conclusively binding upon the bankruptcy courts. The Circuit Court appears to follow the theory that bankruptcy courts are powerless to deviate from State laws in any respect. This error is apparent in the following decisions:

> *In re. Knox-Powell-Stockton Co., Inc.,* 100 Fed. (2d) 979;
>
> *Laugharn v. State of California,* 77 Fed. (2d) 1005.

The governing rule, however, which has been formulated and announced by this Honorable Court is that where the Bankruptcy Law deals with property rights which are regulated by State laws, the Federal courts in bankruptcy will follow the State courts; but when the language of Congress indicates a policy requiring a broader construction of the statute than the State decision would give it, Federal courts cannot be concluded by them. *Board of Trade of Chicago v. Johnson,* 264 U. S. 1, 68 L. Ed. 533, 44 Sup. Ct. 232.

The Bankruptcy Law is paramount and the jurisdiction of the Federal courts in bankruptcy when properly invoked, to wind up the affairs of an insolvent is essentially exclusive. *Re Watts,* 190 U. S. 1, 47 L. Ed. 933, 23 Sup. Ct. 718.

In the case of *International Shoe Co. v. Pinkus,* 278 U. S. 261, 73 L. Ed. 318, 49 Sup. Ct. 108, this court definitely laid down the rule that the power of Congress,

under Constitution Article I, sec. 8, cl. 4, to establish uniform law on the subject of bankruptcy throughout the United States is unrestricted and paramount.

In the case of *Van Huffel v. Harkelrode,* 284 U. S. 225, 227, 76 L. Ed. 256, 52 Sup. Ct. 115, the right of the bankruptcy court to require the sale of property subject to a State lien for taxes was challenged. In that case this Honorable Court held:

> "No good reason is suggested why liens for State taxes should be deemed to have been excluded from the scope of this general power to sell free from encumbrances. Section 64 of the Bankruptcy Act grants to the court express authority to determine 'the amount or legality' of any tax. * * * Realization upon the lien created by the State law must yield to the requirements of bankruptcy administration."

Illustrative of the intention of Congress to retain the power to subject statutory tax liens to rules of procedure and administration defined under the Bankruptcy Act is section 67c of the Bankruptcy Act of 1938, which reads as follows:

> "Where not enforced by sale before the filing of a petition in bankruptcy or of an original petition under chapter X, XI, XII, or XIII of this Act, though valid under subdivision b of this section, statutory liens, including liens for taxes or debts owing to the United States or to any State or subdivision thereof, on personal property not accompanied by possession of such property, and liens, whether statutory or not, of distress for rent shall

be postponed in payment to the debts specified in clauses (1) and (2) of subdivision a of section 64 of this Act, and, except as against other liens, such liens for wages or for rent shall be restricted in the amount of their payment to the same extent as provided for wages and rent respectively in subdivision a of section 64 of this Act."

Under this enactment Congress subjects statutory liens, including liens for taxes owing to any State or subdivision thereof, to postponement in payment to various other debts. If it were the intention of Congress to completely deny the recognition of statutory liens for taxes, it would have the right by the enactment of appropriate legislation to effect such a result.

The State of New York in the case of *New York v. Irving Trust Co.,* 288 U. S. 329, 77 L. Ed. 815, 53 Sup. Ct. 389, challenged the right of the bankruptcy court to disallow a claim for State taxes because of the expiration of a bar order. Here again the United States Supreme Court upheld the paramount power of the bankruptcy court, and said:

> "The Federal government possesses supreme power in respect of bankruptcies. *International Shoe Co. v. Pinkus,* 278 U. S. 261, 265, 73 L. Ed. 318, 320, 49 Sup. Ct. 108. If a state desires to participate in the assets of a bankrupt, she must submit to appropriate requirements by the controlling power; otherwise, orderly and expeditious proceedings would be impossible and a fundamental purpose of the Bankruptcy Act would be frustrated."

It has been held that in bankruptcy administration the Federal court is not concerned with State statutes relating to preferences which provide a different test of liability from that contained in section 60 of the Bankruptcy Act. *Carey v. Donohue,* 240 U. S. 430, 60 L. Ed. 726, 36 Sup. Ct. 386.

Nor is the matter of the possibility of the bankruptcy court impairing the obligation of contracts, important. An interesting illustration of the right and authority of Congress in bankruptcy legislation to impair the obligation of contracts was evidenced in that provision of section 77b of the Bankruptcy Act, being subdivision (b) (10) of that section wherein there was a limitation to three years on the amount which a lessor may claim on account of the rejection of a lease in proceedings under the Bankruptcy Act to reorganize the lessee. This court in the case of *Kuehner v. Irving Trust Co.,* 299 U. S. 445, 452, 81 L. Ed. 340, 57 Sup. Ct. 298, held that section did not violate the due process clause of the Fifth Amendment of the Constitution and stated the rule in the following pertinent language:

> "The equitable distribution of the bankrupt's assets, or the equitable adjustment of creditors' claims in respect of those assets, by way of reorganization, may therefore be regulated by a bankruptcy law which impairs the obligation of the debtor's contracts. Indeed every bankruptcy act avowedly works such impairment. While, therefore, the Fifth Amendment forbids the destruction of a contract it does not prohibit bankruptcy legislation affecting the creditor's remedy for its enforcement against the debtor's as-

sets, or the measure of the creditor's participation therein, if the statutory provisions are consonant with a fair, reasonable, and equitable distribution of those assets."[2]

See also:

> *Louisville etc. Bank v. Radford,* 295 U. S. 555, 79 L. Ed. 1593, 55 Sup. Ct. 854.

The court has held that the Bankruptcy Act has a two-fold purpose, to-wit, (1) to convert the estate into cash and to distribute it among creditors, and (2) to then give the bankrupt a fresh start with such exemptions and rights as the statute left untouched. *Burlingham v. Crouse,* 228 U. S. 459, 57 L. Ed. 920, 33 Sup. Ct. 564; *Central Trust Co. of Ill. v. Chicago Auditorium Assn.,* 240 U. S. 581, 60 L. Ed. 811, 36 Sup. Ct. 412; *Williams v. U. S. F. & G. Co.,* 236 U. S. 549, 59 L. Ed. 713, 35 Sup. Ct. 289.

Section 57j of the Bankruptcy Act was enacted for the purpose of giving effect to that purpose of the Bankruptcy Act which is dedicated to effecting an equitable distribution of the bankrupt's estate amongst creditors.

In its decision in the case of *Kothe v. Taylor Trust,* 280 U. S. 224, 227, 74 L. Ed. 382, 50 Sup. Ct. 142, wherein the court declared: "The broad purpose of the Bankruptcy Act is to bring about an equitable distribution of the bankrupt's estate among creditors holding just demands *based upon adequate consideration.*" (Italics ours.)

Note that this court recognized that it was not only the justice of the demand which would qualify the claim for distribution among creditors. The court was interested in directing that the claim should be both just and based upon "*adequate consideration*". The tax of the State of California in this case may be just and the consideration may be justified by virtue of the fact that one using the streets and highways of the State of California should contribute to the cost of such use. The only justification, however, for the recovery of the penalties, as in this case, is the fact that a fine or punishment is imposed upon the taxpayer for failing to make timely payment of the tax. This is not an adequate consideration as recognized by Congress, because section 57j expressly prohibits its recognition. Congress had a right to determine that such a claim is not sufficiently based upon an adequate consideration to share with general creditors who have just claims based upon *adequate consideration*. In so far as any State law interferes with the provisions of Congress for the administration of bankruptcy estates, such State laws are subordinate to and inferior to the paramount jurisdiction of the bankruptcy court which is charged with the duty of effecting equitable distribution amongst creditors of the insolvent's estate. Thus, in the case of *New York v. Irving Trust Co., supra,* the court held that the State must submit to the appropriate requirements of the bankruptcy court or "otherwise, orderly and expeditious proceedings would be impossible and a fundamental purpose of the Bankruptcy Act would be frustrated".

Conclusion.

Respondents conclude their brief with a quotation from the case of *Bull v. United States,* 295 U. S. 247, at 259, 55 Sup. Ct. 695 at 699, in which the Court said:

> "Taxes are the life blood of government and their prompt and certain availability an imperious need."

With this policy petitioner is fully in accord. However, Congress has wisely provided that only actual taxes and not punitive measures are to be distributable in the liquidation of a bankruptcy estate. To permit taxing bodies to receive preference not only as to taxes but also as to penalties, when the assets of a bankruptcy estate are being salvaged for general creditors, is to permit the sacrifice of the rights of actual creditors who have parted with good and valuable considerations for the benefit of taxing bodies who seek not only the tax, but the penalties which are included only as a club for the enforcement of the collection of taxes. The intention of Congress was clear. Congress made provision for the equitable distribution of such salvaged assets. We believe that we are giving effect to such intention of Congress in asking that the decision of the Circuit Court of Appeals be reversed.

Respectfully submitted,

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